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THE FIRST 100 HOURS:
Domestic Energy Disincentives

January 2007

Democrat Proposal: During the week of January 16th, the Democrats are planning to bring a bill to the House floor that would provide disincentives for the domestic production of oil and gas, capture additional royalties from some existing oil and gas leases, and steer additional federal dollars to alternative energy sources such as wind, solar, and biomass. Neither text nor a detailed summary of the legislation has been made available.

Note: Although a rule for the consideration of the domestic energy disincentives bill has not yet been reported, it is likely that the consideration will mirror that of the 100-Hour Agenda bills provided for in H.Res. 6 (the Democrat House Rules changes) passed by the House on January 5th, as follows:

- Waives all points of order against the consideration of the bill;
- Waives all points of order against the bill itself;
- Closes the bill to floor amendments;
- Considers the previous question as ordered;
- Provides for three total hours of debate (equally divided); and
- Allows one motion to commit with or without instructions.

In other words, this bill will likely come to the House floor under a closed rule and without the applicability of any of the new House rules that the Democrats have implemented.

Payment of Oil and Gas Royalties

The energy disincentives bill will reportedly require the renegotiation of federal oil and gas leases in the Gulf of Mexico from 1998 and 1999 that did not include royalty price thresholds (because of an oversight by the Clinton Administration's Department of the Interior). These thresholds, if applied as in most other leases, should have required increased royalty payments to the Treasury when oil prices rose above the thresholds. The Government Accountability Office has estimated that the error has already resulted in $2 billion in lost royalty payments and could yield an additional $8 billion loss over the life of the leases.

The legislation likely will "recapture" this lost revenue by using Republican-sponsored language that was included in the House-passed OCS drilling bill. That language would institute a "resource conservation" fee of $9 per barrel of oil or $1.25 per million British thermal units of natural gas on companies that do not voluntarily renegotiate their leases from

1998 and 1999. Another possible recapture method could be a Rep. Markey-sponsored provision to bar oil companies from bidding on future lease sales unless they renegotiate the old leases.

Oil and Gas Domestic Disincentives

The bill will likely repeal various tax incentives for (i.e. increase taxes on) domestic oil and gas production, though details remain speculative.

One possible tax increase would be the denial of a corporate tax deduction for income attributable to the production, refining, processing, transportation, and distribution of oil, natural gas, or any primary product thereof, beginning in 2008. This provision would likely amount to a multi-million tax increase on oil and gas companies.

Another possible tax increase would be the extension from five years to seven years of the amortization of geological and geophysical expenditures for certain large oil companies for the purposes of calculating a tax deduction (and thereby making the resulting tax deduction smaller each year).

It is unclear whether the legislation will include the rebuke of a common accounting method in the oil and gas industry—the "last-in-first-out" (LIFO) method of accounting for inventory. Reports indicate that a LIFO proposal could yield a multi-billion-dollar tax increase on oil and gas inventories.

Creation of a Renewable Energy and Conservation Reserve

The bill would likely provide that the additional revenue received in the U.S. Treasury because of the other provisions in this legislation would be held in a separate account known as the "Strategic Energy Efficiency and Renewables Reserve." This reserve fund would be used to offset the cost of any subsequent legislation providing, extending, modifying, or funding tax incentives for investments in renewable energy and energy efficiency through research, development, demonstration or deployment.

Additional Background:

Payment of Oil and Gas Royalties

Several oil companies, including BP, ConocoPhillips, and Shell, have already signed an agreement with the federal government to begin applying the royalty price thresholds to oil and gas drilled after October 1, 2006. [Other companies have not yet renegotiated.] Nevertheless, with this legislation, the Democrats are trying to recapture the $2 billion in "unpaid royalties" to fund other initiatives.

On May 18, 2006, the House voted 252-165 (http://clerk.house.gov/cgi-bin/vote.asp?year=2006&rollnumber=167) to prohibit federal funds from being used to issue any new oil and gas leases on the Outer Continental Shelf to any lessee under an existing lease where such lease is not providing the "proper" royalties based upon market price.

Oil and Gas Domestic Disincentives

Current law (26 U.S.C. 199), passed as part of the "FSC-ETI" bill (Public Law 108-357), provides for a (9%) corporate tax deduction for most domestic economic manufacturing and production (except retail food sales and the transmission or distribution of electricity, natural gas, or potable water). The underlying bill may add oil and gas production and distribution as an exception to this deduction so that they could not deduct such expenditures (and thus be subject to a substantial tax increase). This would amount to a multi-million-dollar tax increase on oil and gas companies that could yield higher energy prices for consumers.

A proposed limitation on "last-in-first-out" (LIFO) inventory accounting could impose a large tax increase on a handful of the largest U.S. oil and gas companies. LIFO tracks and values a company's inventory for purposes of determining the cost of goods sold, which is then deducted by the business from its gross income, and for determining the value of its inventory at year end. LIFO, which has been allowed under the federal tax code since the 1930s, is based upon the assumption that the last goods brought into inventory are the first goods sold. Code since the 1930s to determine a taxpayer's income.

The Democrat proposal could require only large, integrated oil and gas companies to adjust the historical value of their 2006 ending inventory volumes by a purely arbitrary amount ($18.75 per barrel in an earlier proposal), thus requiring large lump-sum payments from such companies.

Democrats have cited exorbitant oil-industry profits as the prime motivation behind this legislation. However, over the last five years, the oil and gas industry's earnings per dollar of sales have averaged 5.9 cents, compared to 5.2 cents average for all of American industry. (http://www.api.org/statistics/earnings/upload/oil-gas-earnings-vs-all%20industry.pdf)

Creation of a Renewable Energy and Conservation Reserve

According to the Department of Energy's Energy Information Administration (EIA), all renewable energy sources provide 3.1% of our current energy supply. Wind power produces 0.1% of our energy, and solar provides less than 0.01% of our energy supply, while ethanol provides 1.2% of our transportation fuel and hydrogen fuel cells are not currently in mass production.

According to the Renewable Fuels Association, the U.S. uses 25% of the world's energy and produces 35% of the world's ethanol, which is second only to Brazil. After Brazil, the U.S. produces more than all other countries combined. The EIA predicts no significant usage of E85 (85% ethanol/15% gasoline) before the year 2020, and it predicts that E10 (10% ethanol/ 90% gasoline as used today) will supply just 3.5% of the nation's fuel by 2030. The EIA notes that ethanol yields about one-third less mileage than gasoline and cannot be transported in pipelines.

The EIA reports that hydrogen fuel requires large amounts of energy to produce, must be stored near absolute zero, and is highly explosive.

The EIA also reports that solar power requires tremendous amounts of space to produce (6,750 acres to produce the same amount of power that a conventional gas-fired 500 megawatt plant produces on 55 acres) and requires duplicate conventional capacity for when the sun is not shining. The EIA projects that solar will supply 0.6% of the country's total energy supply by the year 2030.

Wind power also has a space problem. Windmills require 29,250 acres to produce the same amount of power that a conventional gas-fired 500 megawatt plant produces on 55 acres and requires duplicate conventional capacity for when the wind is not blowing. The EIA projects that wind will supply 0.5% of the country's total energy supply by the year 2030.

The EIA projects that all biomass will supply 0.6% of the country's total energy supply by the year 2030.

The EIA also notes that the generation of electricity is projected by year 2030 to come 61% from coal, 17% from natural gas, 16% from nuclear energy, 9% from renewables (same percentage as in 2005), and 2% from petroleum.

Source for much of the above: http://www.eia.doe.gov/oiaf/aeo/index.html.

Possible Conservative Concerns: Some conservatives might be concerned that this legislation's financial punishment of oil and gas companies, which provide the vast majority of this country's energy resources, could economically discourage domestic energy exploration and production and encourage more exploration overseas and a greater reliance on foreign energy sources. Conservatives may also be concerned at the inclusion of tax increases in an energy bill. And conservatives may be concerned at the creation of a new reserve in the Treasury for renewable energy sources that are not likely to be major energy sources in America for the next several decades.

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